THE WALL STREET JOURNAL. FRIDAY, SEPTEMBER 30, 2005

Bayou Duo Plead Guilty to Fraud

Hedge Fund Never Made a Profit And Traded Little in Past Year As Founders Made Pie-in-Sky Bets

BAYOU MANAGEMENT, the collapsed Connecticut hedge-fund firm, never made a profit despite years of sunny reports to clients, and it mostly stopped trading securities in mid-2004 as its founders tried desperately to recoup losses with fanciful bets totaling $150 million—all that was left of the $450 million it had collected from investors, authorities said.

Those details emerged as Bayou Management's two founders, Samuel Israel III and Daniel

By ***Kara Scannell, Ian McDonald*** *and* ***Ianthe Jeanne Dugan***

Marino pleaded guilty in federal court in White Plains, N.Y., yesterday to criminal-fraud charges.

The pair were also sued by the Securities and Exchange Commission and the Commodity Futures Trading Commission. The SEC civil lawsuit implicated but didn't name as a defendant an unidentified "former Bayou principal." That was a reference to James Marquez, who left the firm several years ago, a person familiar with the situation said.

An attorney for Mr. Marquez said he has been communicating about the matter with authorities on behalf of his client.

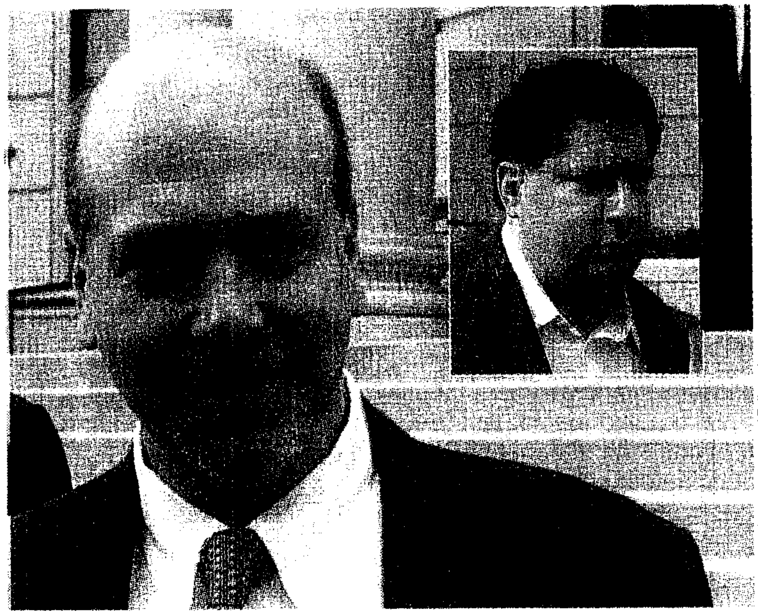
In court yesterday, Mr. Marino admitted to conspiracy, investment-adviser fraud, mail fraud and wire fraud. Mr. Israel admitted to the same underlying allegations in three counts, but not the wire-fraud count.

Both were released on a $500,000 bond. Mr. Marino faces as much as 50 years in prison, while Mr. Israel faces as much as 30 years. Sentencing was set for Jan. 9.

Mr. Israel is the Stamford-based money-management firm's chief executive and chief investment officer. Mr. Marino is its chief financial officer. Mr. Marino reached a plea agreement with prosecutors, which sometimes can involve promises to cooperate, but prosecutors declined to say whether he was helping investigators. Mr. Israel pleaded guilty without reaching a deal with prosecutors.

"I knew that what I was doing was false and

Please Turn to Page C4, Column 5



Bloomberg News/Landov; AP (inset)

'False and Fraudulent': *Bayou Management's* **Samuel Israel III** *and* **Daniel Marino** *(inset) leave court yesterday.*

Continued From Page C1

fraudulent," Mr. Israel said in an afternoon court hearing.

"I deeply regret my actions," Mr. Marino said in an earlier hearing. "I am very sorry in more words than I can say." During the hearing, he said he "acted in concert with" the chief investment officer and a trader whom he didn't identify.

In court, Mr. Marino agreed to forfeit all claims on $100 million in Bayou assets seized by Arizona authorities in May, as well as his $3 million home in Westport, Conn., a bank account and all interests in two side businesses—IM Partners, a venture-capital firm he started with Mr. Israel, and IMG LLC.

Mr. Israel didn't agree to forfeiture, but prosecutors are seeking $450 million from him, the amount authorities say Bayou has collected from investors since it was founded in 1996. Some of that money was returned to investors over the years, but most is unaccounted for. Authorities said in court papers that Messrs. Israel and Marino "stole" some of the money by collecting performance fees based on bogus profits.

By April 2004, at a time when Bayou was telling investors that its assets totaled $410 million, it had only $150 million left, the SEC said. Today, the only known remaining funds are the $100 million seized by Arizona authorities, who acted after concluding that the money was being quickly shifted among banks in a fraud scheme.

The SEC said that $100 million was sunk into a "patently dubious" investment that, as previously reported, was supposed to turn the money into $7.1 billion in 10 years.

Much of the remaining $50 million likewise was invested in failed private investments. "The private-placement transactions turned out to be frauds," prosecutors said. The authorities didn't say whether Messrs. Israel and Marino knew the last-ditch investments were frauds or were unwitting participants in those schemes.

Reached late Wednesday, Mr. Marino said, "I never managed any money. Sam Israel managed the money." He declined to elaborate. A lawyer for Mr. Israel declined to comment.

Prosecutors said Bayou had "sustained consistent losses" since 1996. The SEC put the total theft and losses at "tens of millions of dollars." The authorities said Bayou began lying to investors almost immediately after opening for business. In 1998, after losing millions, the firm's principals dismissed Bayou's independent auditing firm and set up a "sham" firm, which fabricated audits that were sent to investors.

That kept the money flowing, with investor deposits totaling $125 million in 2003 alone. Bayou lost $35 million that year, but the firm told investors it had gained more than $25 million. In all, Bayou's four funds lost $49 million that year. But because the firm relied on rapid-fire buying and selling akin to day-trading, its securities trading arm, which collected commissions from every trade, earned $29 million.

The principals also made money on performance fees based on bogus profits. Between 2000 and 2004, the CFTC says Bayou falsely reported $117 million in profits for fund shareholders, and its principals collected more than $23 million in management fees.

The investigation was aided by a six-page "suicide note and confession" found on Mr. Marino's desk by a Bayou investor last month that provided a year-by-year account of the fraud and implicated both Messrs. Israel and Marquez, Stamford police say.

The scandal, which also has prompted civil lawsuits by investors, has raised questions about the investment advisers who steered clients' money toward Bayou. "This case demonstrates that even experienced investors in hedge funds can be victims of unscrupulous operators," said Michael J. Garcia, the U.S. attorney for the Southern District of New York.

On paper, Messrs. Israel and Marino seemed a perfect pair to found and run hedge funds, with both touting long careers in the industry.

But financial advisers and investors may have failed to heed signs that the firm didn't always play by the rules. These included scrapes with securities and banking regulators, apparent exaggerations in Mr. Israel's résumé, a lawsuit alleging unexplained withdrawals and possible rules violations, and public records showing Mr. Marino's ties to the accounting firm that did Bayou's supposedly independent audits. Authorities now say that the firm, Richmond-Fairfield Associates, was a "sham," and that Mr. Marino answered inquiries to it under the fictitious name "Matt Richmond." Such tidbits from the duo's business backgrounds were easy to find via Internet research and other inquiries.

Less obvious were aspects of the duo's personal behavior. Police arrested Mr. Israel on the evening of May 11, 1996, for operating a vehicle under the influence of alcohol on New York City's Upper West Side, court records show. The police also "recovered 1 bag containing crack/cocaine from defendant's wallet" and charged him with criminal possession of illegal drugs, the records show. The next day, Mr. Israel pleaded guilty to drunken driving; the drug charge was dropped.

Mr. Israel long has suffered chronic back pain, undergoing at least two surgeries, and in recent years, he became increasingly reliant on painkillers, three former associates say. He said in court yesterday that he in the past had sought treatment for substance abuse.

In the final months, Mr. Israel rarely turned up at the firm's offices. In explaining his absences and the lack of securities trading, Mr. Israel told underlings he was trading from a $13,000 trading desk he had installed in his rented mansion in Mount Kisco, N.Y., associates say.

Messrs. Israel and Marino had a volatile relationship that frequently escalated into heated arguments. Former employees say the two once exchanged punches in the firm's parking lot. Mr. Marino's "confession" note said that Mr. Israel pointed a gun at his chest during a recent dispute, police say.

Former employees describe Mr. Israel as a warm and caring person who hugged staffers and seemed interested in their lives. Aside from dust-ups with Mr. Marino, Mr. Israel was rarely upset in the office and kept board games handy, a hobby of his.

The pair also created IM Partners, a private-equity venture, that sank millions into obscure, Isle of Man-based outfits, including **Kycos**, an anti-money-laundering firm whose name stands for Know Your Customer Outsourcing Services.